# BUYING AND SELLING A BUSINESS
# PRACTICAL TAX CONSEQUENCES


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# OVERVIEW OF TRANSACTIONS

- Tax Free Reorganizations:

  Type A – Merger

  Type B – Stock for Stock

  Type C – Stock for Assets

  Type D – Spin Off, Split Off, Split Up, and Type D Acquisitive Reorganizations

- Taxable Transactions:

  Stock Sale

  Asset Sale

- Foreign Corporations
- S Corporation Strategies
- Partnership Techniques

# TAXABLE VS. TAX FREE

- Type of Acquisition Currency
  - Stock
  - Securities/Debt
  - Deferred payments, earnouts
  - Compensatory
- Nature of the Buyers and Seller
  - Foreign Parties
  - Tax Attributes of Parties
- Shareholder Level Considerations
  - Tax Sensitivity of Shareholders
  - Appetite for Complexity & Risk

# CONTINUITY OF INTEREST

- IRS – 50% Safe Harbor, Rev. Proc. 77-37
- John A. Nelson – 38% Stock
- Miller v. CIR – 25% Stock
- Kass v. CIR – 16% Stock is Insufficient

- Value – 2007 Regulations address changes in value between the date of signing and close; if fixed consideration, (1) stock consideration is valued as of last business day before the first day the contract is binding and (2) if a portion of the fixed consideration is other property identified by value, then the specified value is used for that portion (see Reg. 1.368-1T(e)(2)). Consideration is "fixed" if contract states exact number of shares and other cash or property to be exchanged
- Post transaction sales and redemptions

# TAX FREE REORGANIZATIONS

- Type A – Merger
- Type B – Stock for Stock
- Type C – Stock for Assets
- Type D – Spin Off, Split Off, Split Up, and Type D Acquisitive Reorganizations
- Ruling Guidelines
  - Rev. Rul. 77-37
  - Rev. Proc. 86-42
  - Rev. Rul. 73-54 (terms)
  - Rev. Proc. 89-50
  - Rev. Proc. 96-30 (Type D Checklist)

# TYPE A REORGANIZATIONS – SECTION 368(a)(1)(A) STATUTORY MERGER


- Statutory Merger – 2 or more corporations combined and only one survives (Rev. Rul. 2000-5)
- Requires strict compliance with statute
- Target can be foreign; Reg. 1.368-2(b)(1)(ii)
- No “substantially all” requirement
- No “solely for voting stock” requirement

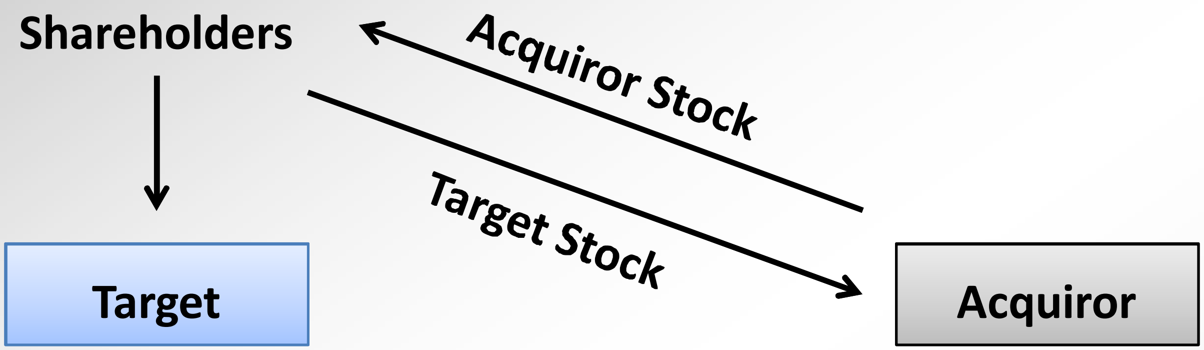
<u>Requirements:</u>

- Necessary Continuity of Interest
- Business Purpose
- Continuity of Business Enterprise
- Plan of Reorganization
- Net Value

<u>Tax Effect:</u>

- Shareholders – Gain recognized to the extent of boot
- Target – No gain recognition
- Acquiror takes Target’s basis in assets plus gain recognized by Shareholders
- Busted Merger – taxable asset sale followed by liquidation

# TYPE B REORGANIZATIONS – SECTION 368(a)(1)(B) STOCK FOR STOCK




- Acquisition of stock of Target, by Acquiror in exchange for Acquiror voting stock
- Acquiror needs control of Target immediately after the acquisition
- Control = 80% by vote and 80% of each class

- Acquiror’s basis in Target stock is the same as the Shareholder’s Solely for voting stock
- No Boot in a B
- Reorganization Expenses – distinguish between Target expenses and Target Shareholder expenses (Rev. Rul. 73-54)
- Creeping B – old and cold stock purchased for cash should not be integrated with stock exchange

# TYPE C REORGANIZATIONS – SECTION 368(a)(1)(C) STOCK FOR ASSETS


- Acquisition of substantially all of the assets of Target, by Acquiror in exchange for Acquiror voting stock
- "Substantially All" – at least 90% of FMV of Net Assets and at least 70% of FMV of Gross Assets
- Target must liquidate in the reorganization
- 20% Boot Exception – Acquiror can pay boot (non-stock) for Target assets, up to 20% of total consideration; liabilities assumed are not considered boot unless other boot exists

- Reorganization Expenses – Aquiror may assume expenses (Rev. Rul. 73-54)
- Assumption of stock options not boot
- Bridge loans by Acquiror are boot
- Redemptions and Dividends – who pays and source of funds



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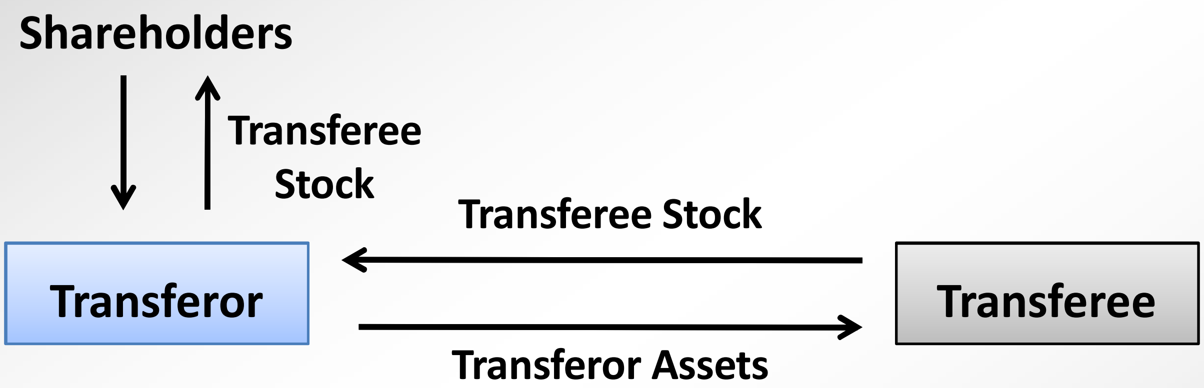
# TYPE D REORGANIZATIONS – SECTION 368(a)(1)(D) DIVISIVE SPIN OFF, SPLIT OFF, SPLIT UP




- Divisive – transfer by a corporation of all or part of its assets to another corporation if, immediately after the transfer, the transferor or its shareholders are in control of the transferee corporation. Stock or securities of the transferee must be distributed under the plan in a transaction that qualifies under Section 354, 355, or 356.



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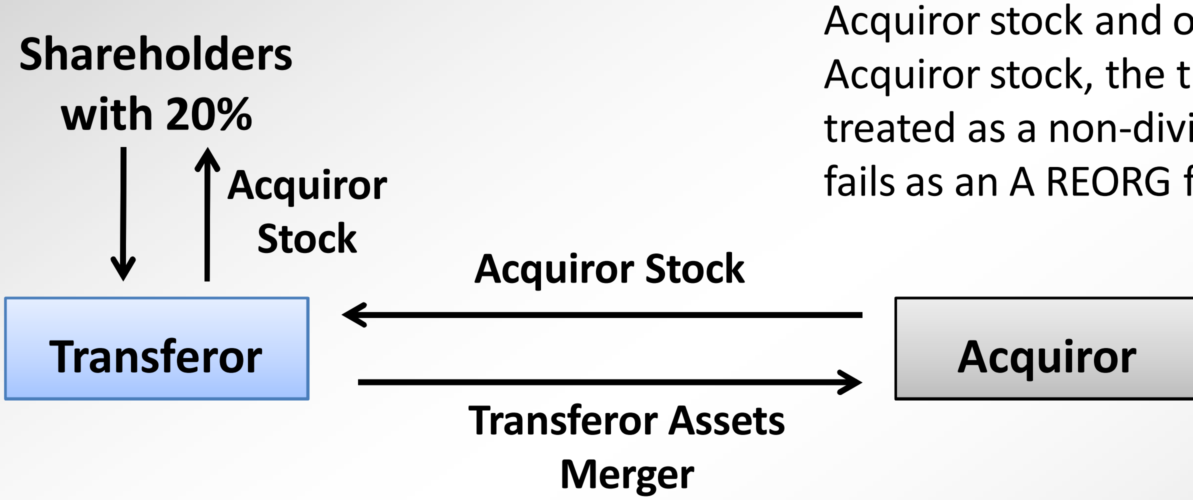
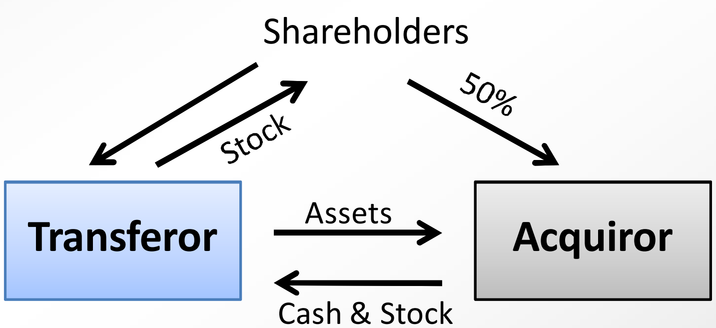
# TYPE D REORGANIZATIONS – SECTION 368(a)(1)(D) NON-DIVISIVE

Merger Treated as Acquisitive D

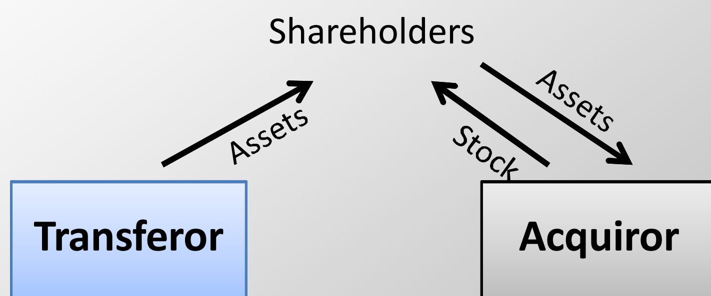
- If shareholders of Transferor stock receive Acquiror stock and own at least 50% of Acquiror stock, the transaction may be treated as a non-divisive D REORG even if it fails as an A REORG for lack of continuity




Failed Type C Treated as D

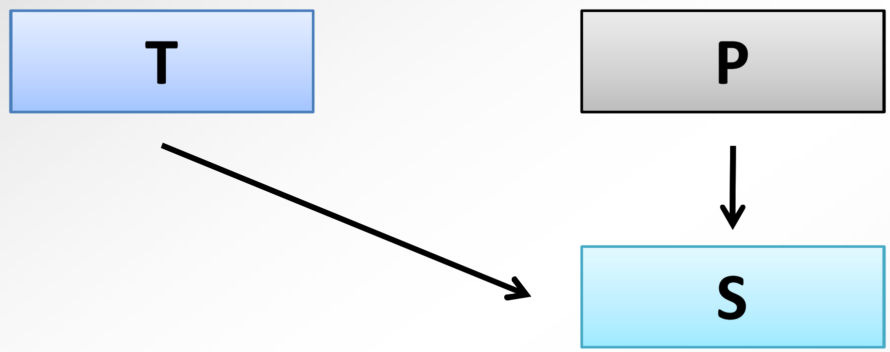



Liquidation / Reincorporation

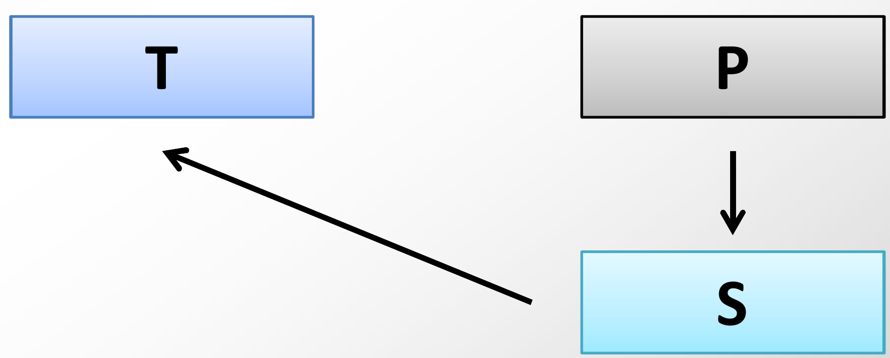


# TRI-ANGULAR OR SUBSIDIARY MERGERS

## 1. Forward Subsidiary Merger




## 2. Reverse Subsidiary Merger



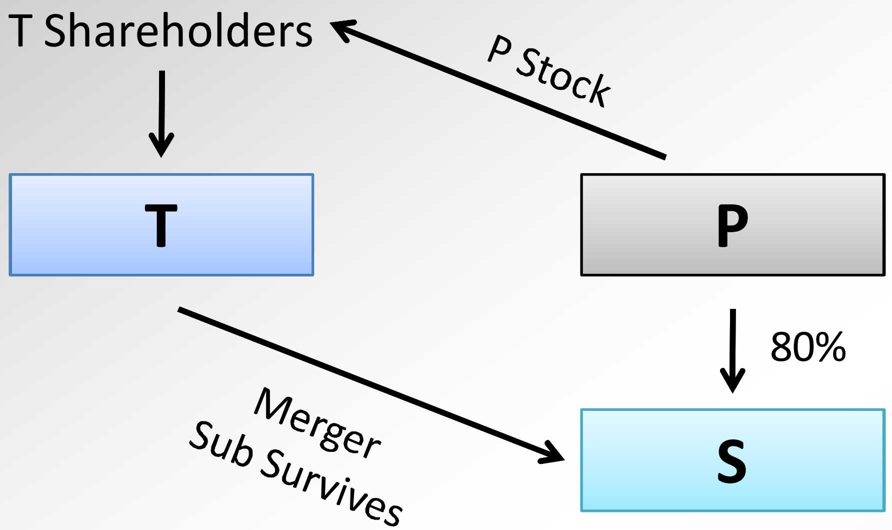

Key:

T = Target

P = Acquiror

S = Merger Sub

# TRI-ANGULAR OR SUBSIDIARY MERGERS




Tax Consequences

• Merger Sub takes Target's basis in assets increased by gain recognized by Target

• P takes "drop down" basis in stock of Merger Sub (same as asset basis)

Section 368(a)(2)(D) Forward Triangular Merger

- A statutory merger of Target into Merger Sub (at least 80% owned by P)
- Substantially all of Target's assets acquired by Merger Sub
- Would have been a good Type A merger if Target had merged into P

Key:

T = Target P = Acquiror S = Merger Sub



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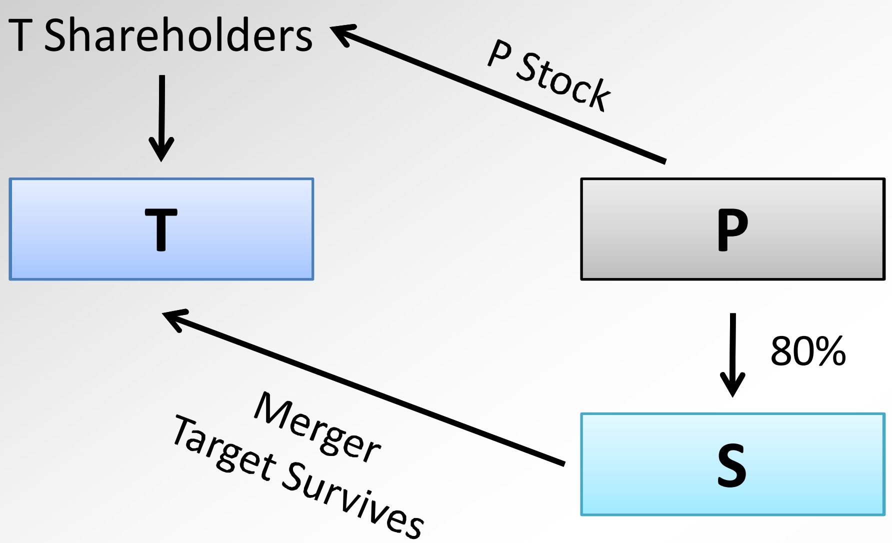
# TRI-ANGULAR OR SUBSIDIARY MERGERS




Tax Consequences

- Non-taxable to Target and carryover basis
- No gain to P and Merger Sub under Sections 1032 and 361
- No gain to Target shareholders except to the extent of boot
- P's basis in Target stock generally is the asset basis, but P can choose to take Target shareholders basis in stock (if it is also a B)
- If transaction is also a 351, P can use Target shareholders' basis plus gain

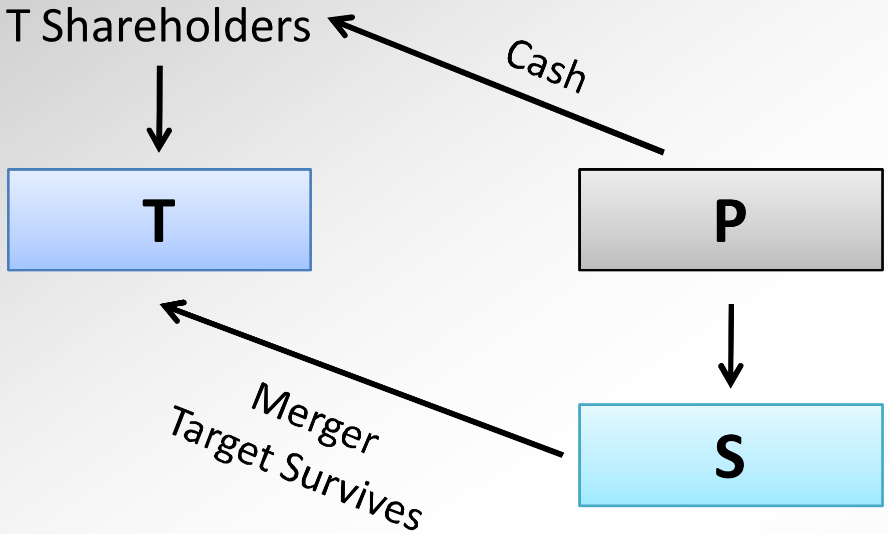
## Section 368(a)(2)(E) Reverse Triangular Merger

- Merger of Merger Sub into Target where (i) Target shareholders surrender control (80% of voting and nonvoting classes of stock) for P voting stock and (ii) Target holds substantially all the assets of Target and Merger Sub

Key:

T = Target P = Acquiror S = Merger Sub

# TAXABLE STOCK PURCHASES




__Cash Reverse Triangular Merger__

__Treated as Stock Sale__

- Shareholders have gain or loss
- P takes cost basis in Target shares

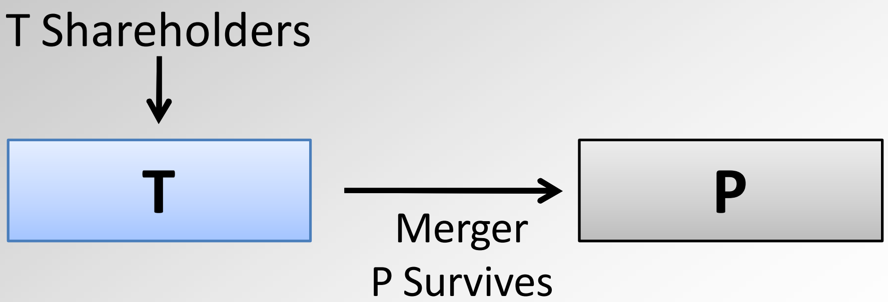
__Key:__

T = Target

P = Acquiror

S = Merger Sub

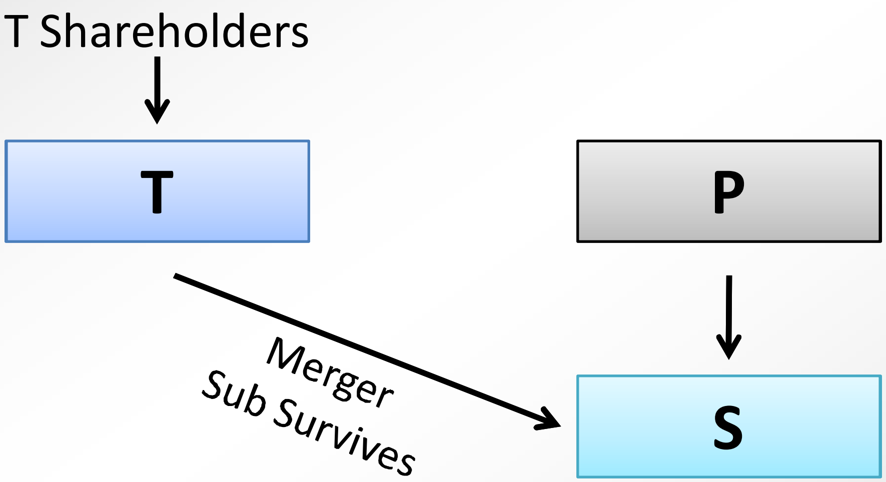
# CASH FORWARD MERGER




## Asset sale followed by liquidation of Target

- Target has gain on sale
- Target shareholders have gain on liquidation (unless 332 applies)
- P takes cost basis in Target assets

**Variation with Merger Sub:**




Key:

T = Target

P = Acquiror

S = Merger Sub

# NET VALUE RULES

- 2005 Proposed Regulation 1.368-1(b)(1): Exchange of no net value (liabilities exceed value) does not qualify as a reorganization
- Example:
  - P owns all of the stock of both S and T. T has assets with FMV of $100 and liabilities of $160, all of which are owed to B. T transfers all of its assets to S in exchange for the assumption of T's liabilities, and T dissolves. The obligation to B is outstanding immediately after the transfer. P receives nothing in exchange for its T stock. Under paragraph (f)(2)(i) of the Reg, T does not surrender net value because the FMV of the property transferred by T ($100) does not exceed the sum of the amount of liabilities of T assumed by S in connection with the exchange ($160). Therefore, under paragraph (f) of the Reg., there is no exchange of net value. See Prop. Reg. 1.368-1(f)(5) Example 3.
- Alabama Asphalt

# SECTION 382 – LIMITATION ON LOSSES AFTER CHANGE IN OWNERSHIP

- Section 381 – Survival of Tax Attributes
- Section 382
  - When there has been an ownership change of a corporation with loss carry forwards, use of Net Operating Losses (NOLs) against future income is limited to the product of the value of the Target and the long term interest rate
  - "Ownership Change" occurs if, within a 3 year testing period, the percentage of stock of Target held by 5 Percent Shareholders increases by more than 50% over lowest percentage held by such shareholders during the test period.

# NON-QUALIFIED PREFERRED STOCK

- Preferred Stock – limited and preferred as to dividends; and does not participate in corporate growth;

  If:

  – (1) shareholder has right to require issuer to redeem
  – (2) issuer is required to redeem
  – (3) issuer has right to redeem and is more likely than not to exercise that right; or
  – (4) dividend rate varies based on interest rate, or commodity price or other index
- Redemption right exercisable within 20 years and not subject to contingency that renders likelihood remote
- Excludes stock compensation that may be repurchased on separation from service
- Conversion feature not enough to participate in growth
- Generally treated as boot to shareholders

# TARGET DEBT SECURITIES

- Exchange of Target securities for P securities is tax free under Sections 354 and 356, to the extent that the principal amount of P debt is less than the principal amount of Target debt
- Portion attributable to cash basis accrued interest is taxable
- Possible COD income
  - Example:
    - Target bonds with an issue price (stated principal amount) of $1,000 exchanged for P stock or debt worth $900; Target has COD of $100

# DIVIDEND EQUIVALENCY

- Section 356(a)(2) – Boot as dividend or capital gain; post-reorganization redemption test of Rev. Rul. 93-61
- *Clark* – hypothetical post-reorganization redemption reduced shareholder's interest from 1.32% to .92% - substantially disproportionate under Section 302(b)(2)
- Section 302(b)(1) – redemption that results in meaningful reduction in voting power is redemption and not essentially equivalent to a dividend
- Section 302(b)(2) – greater than 20% reduction is substantially disproportionate
- E&P Limitation on Dividend – should be Target's E&P but unclear if P's E&P counted; PLR 9118025, PLR 9041086, and PLR 9039029

# CONTINGENT STOCK, ESCROWS, AND EARN-OUTS

- Escrows:
  - Target shareholders usually treated as owner of escrowed P shares unless otherwise agreed
  - especially true if Target shareholders have right to vote and receive dividends
  - not clear who is owner if Target shareholders do not have right to vote or receive dividends
- Earn-Out Stock:
  - Target shareholders not considered owners until P shares are issued
  - Not treated as boot
  - Imputed Interest
- Rev. Proc. 84-42 Ruling Guidelines – use of escrow or contingent stock
  - (1) stock must be distributed within 5 years, subject to escrow or contingency
  - (2) valid business purpose
  - (3) maximum number of shares cannot exceed 50%
  - (4) trigger event not controlled by Target shareholders and not based on tax liability
  - (5) Formula is objective and readily ascertainable
  - (6) Restrictions on assignment and substitution
  - (7) In the case of escrows, P shares shown as issued to Target shareholders, current voting and dividend rights, and vested



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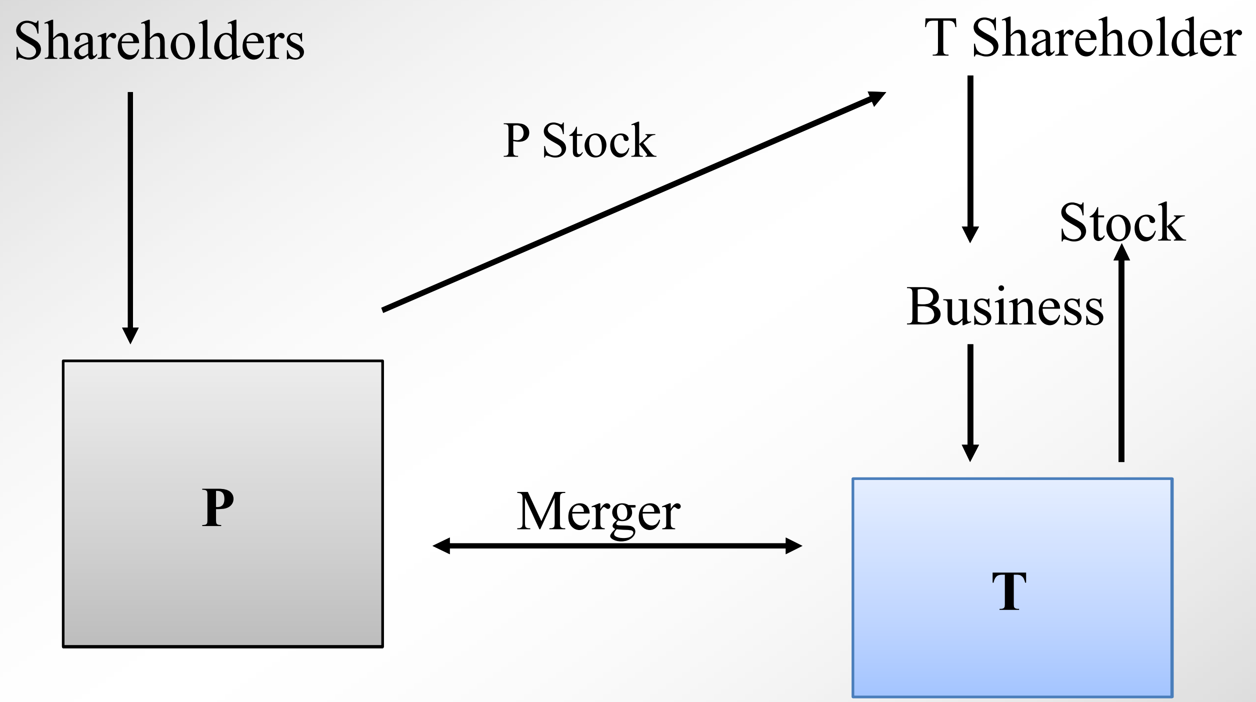
# BUSTED 351




Rev. Ruling 70-140

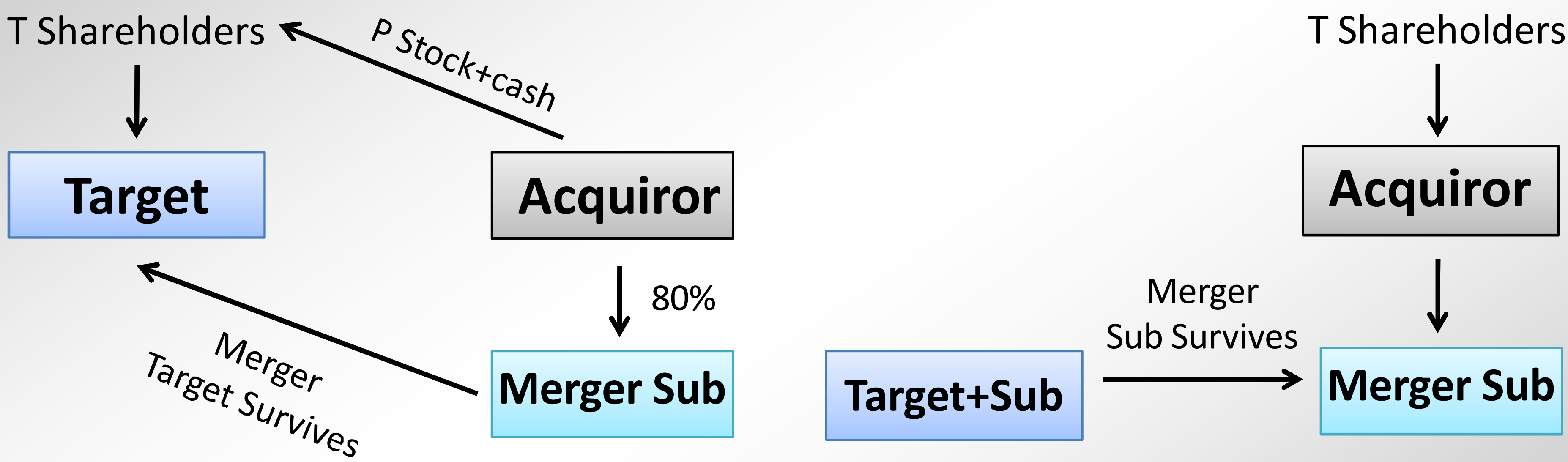
Step 1: Incorporate T
Step 2: Merge T into P

# DOUBLE MERGER

REV. RUL. 2001-46

Step 1: Reverse triangular merger

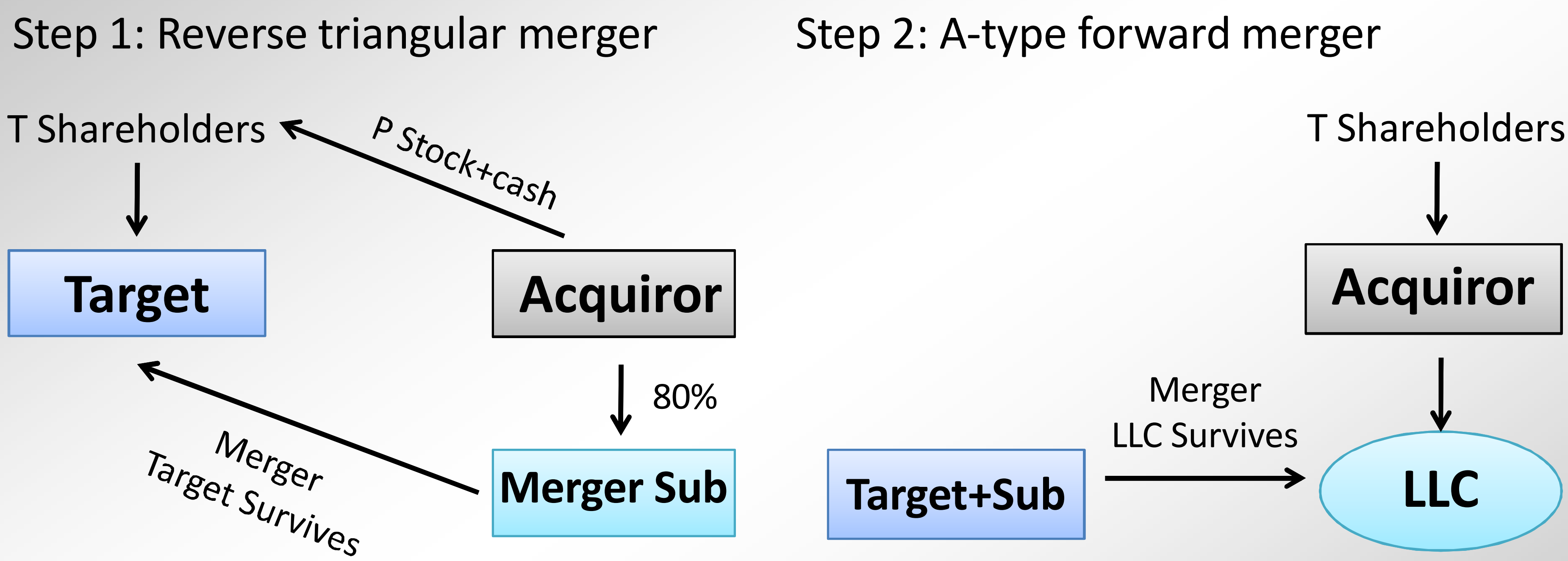
Step 2: A-type forward merger




Tax Benefit: A taxable reverse merger has just one tax on the shareholders, while a taxable forward merger has two taxes (one on shareholders and one on corporation). Intended that entire transaction be a tax-free A-type merger (where 20% boot limitation does not exist). Pairing the two reduces the risk of incurring the corporate level tax in the event the entire transaction is not treated as an A-type merger.

# DOUBLE MERGER – WHOLLY OWNED LLC

## REV. RUL. 2001-46




<u>Tax Benefit</u>: A taxable reverse merger has just one tax on the shareholders, while a taxable forward merger has two taxes (one on shareholders and one on corporation). Intended that entire transaction be a tax-free A-type merger (where 20% boot limitation does not exist). Pairing the two reduces the risk of incurring the corporate level tax in the event the entire transaction is not treated as an A-type merger.



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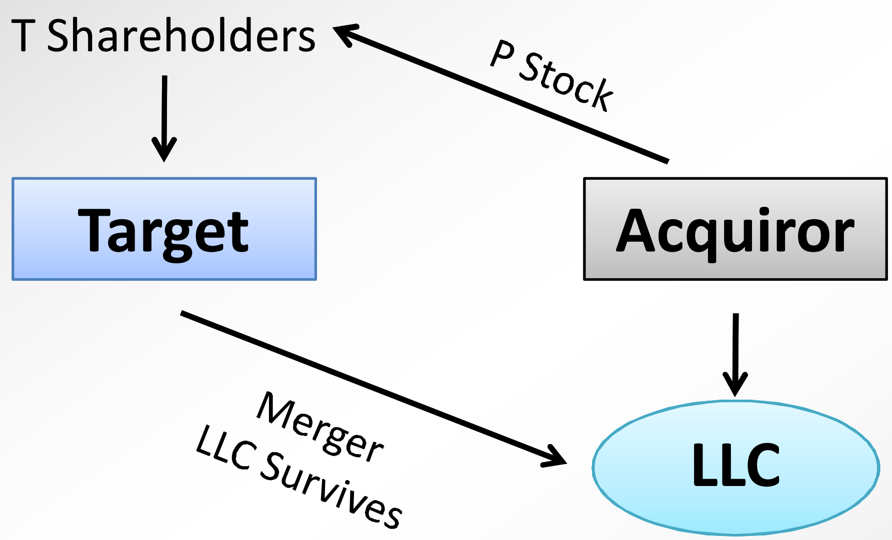
# USE OF WHOLLY OWNED LLC




<u>Merger of Corporation into LLC</u>

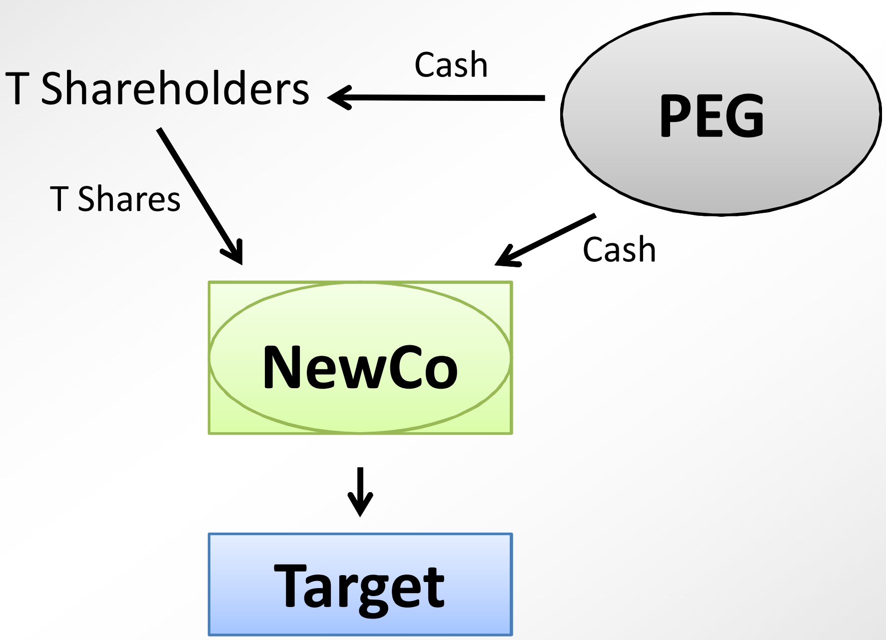
• Reg. 1.368-2(b)(1) – by operation of law, all assets and liabilities of Target become those of LLC, and Target ceases legal existence

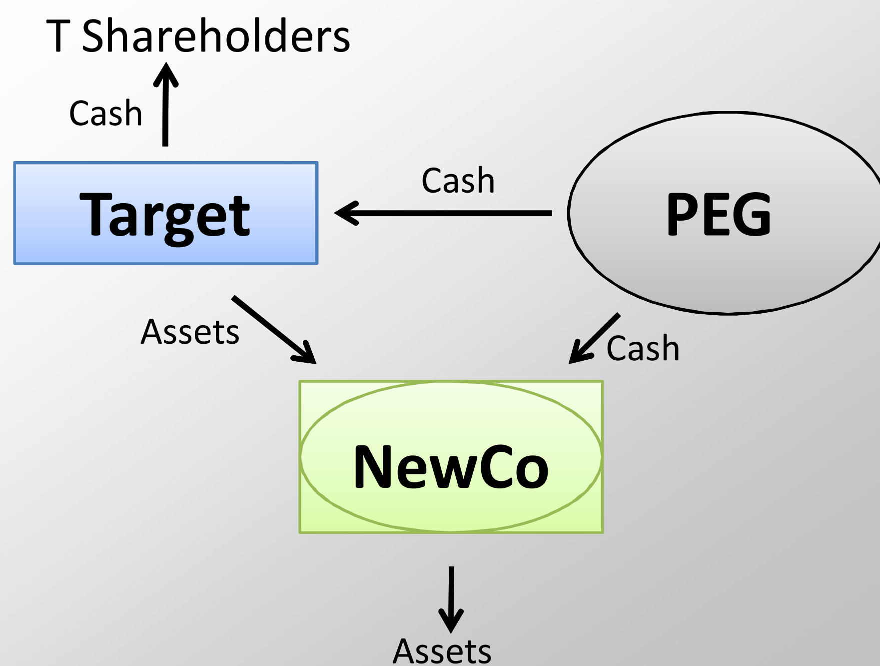
• A Type Reorganization

# SECTION 351 / 721 ROLLOVER

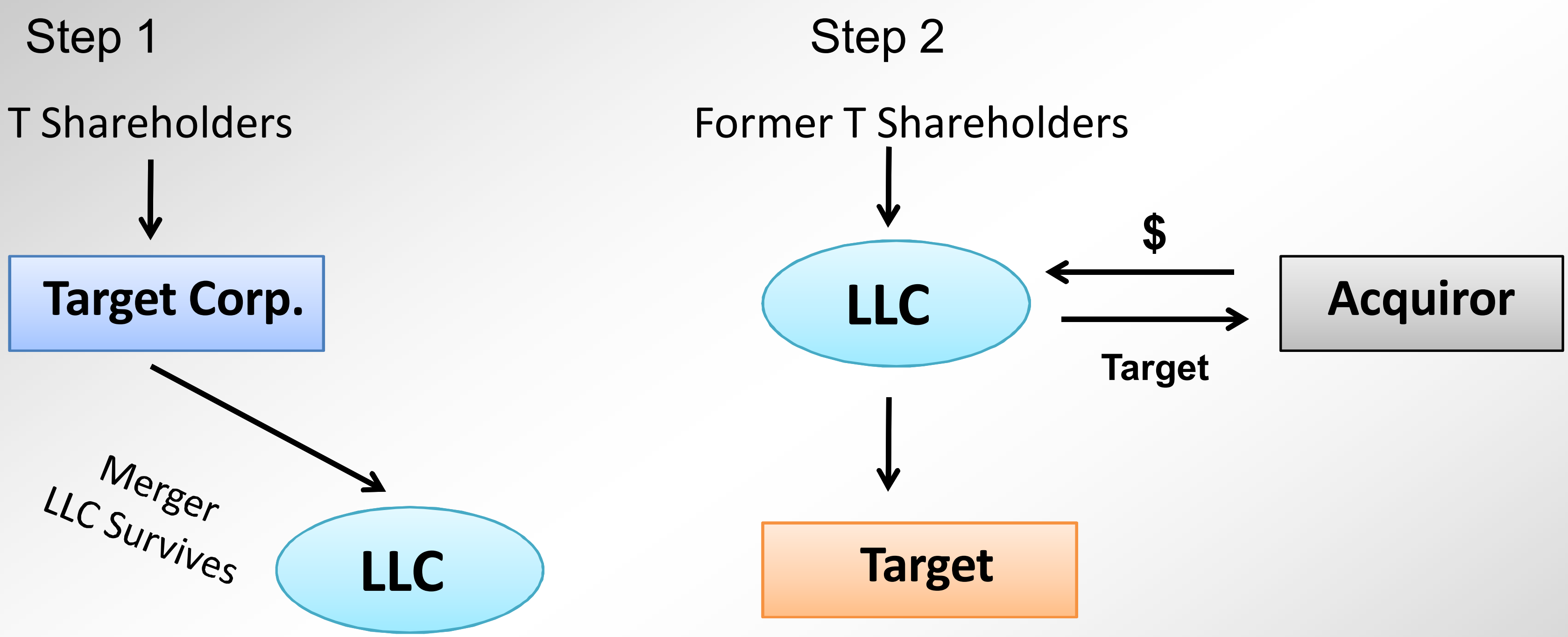

- 80% vote & value
- taxation of boot
- debt + non-qualified voting stock
- assumption of liabilities

<u>Cash out some and rollover</u>



# LLC TECHNIQUES



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# FOREIGN CORPORATIONS

- Section 367(a) – outbound transactions
  - Foreign corporation not treated as a corporation except as provided in regulations
  - Generally, gain recognized unless:
    - No more than 50% of stock of foreign Acquiror received by US transferors,
    - No more than 50% of stock of foreign Acquiror owned after the transfer by US persons that are officers or directors or 5% Target shareholders,
    - Gain Recognition Agreement ("GRA") is entered into by 5% US transferee shareholders
    - 36 month active trade or business test met,
    - No intent to substantially dispose of or discontinue such trade or business,
    - FMV of the assets of transferee must be at least equal to the FMV of the US target, and
    - Tax reporting
- Section 367(b) – inbound and foreign to foreign transfers
  - US Acquiror and foreign Target
    - Target can be treated as a corporation
    - May be income to Target's US shareholders to extent of Target's accumulated E&P



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# FOREIGN CORPORATIONS

- Anti-Inversion Rules – tax outbound reorganization and/or tax foreign Acquiror as a U.S. taxpayer; Code Section 7874
  - If ownership of former U.S. Target shareholders in foreign Acquiror is 80% or more; foreign Acquiror is treated as a U.S. company
  - If ownership continuity is between 60-80%; foreign Acquiror is NOT treated as a U.S. company, but U.S. tax attributes cannot be used to offset gains
  - 20% excise tax on stock-based compensation upon certain corporate inversion transactions
  - 7874 exception available for companies with "substantial business activities" in the foreign jurisdiction; facts and circumstances test compares activities of company in foreign jurisdiction with activities of company globally
- Controlled Foreign Corporations ("CFCs")
  - A foreign entity is classified as a CFC if it has "United States Shareholders" who collectively own *more than* 50% of the voting power or value of the company. For the purposes of the CFC rules, a "United States Shareholder" is defined as US persons holding at least a 10% interest in the foreign corporation.



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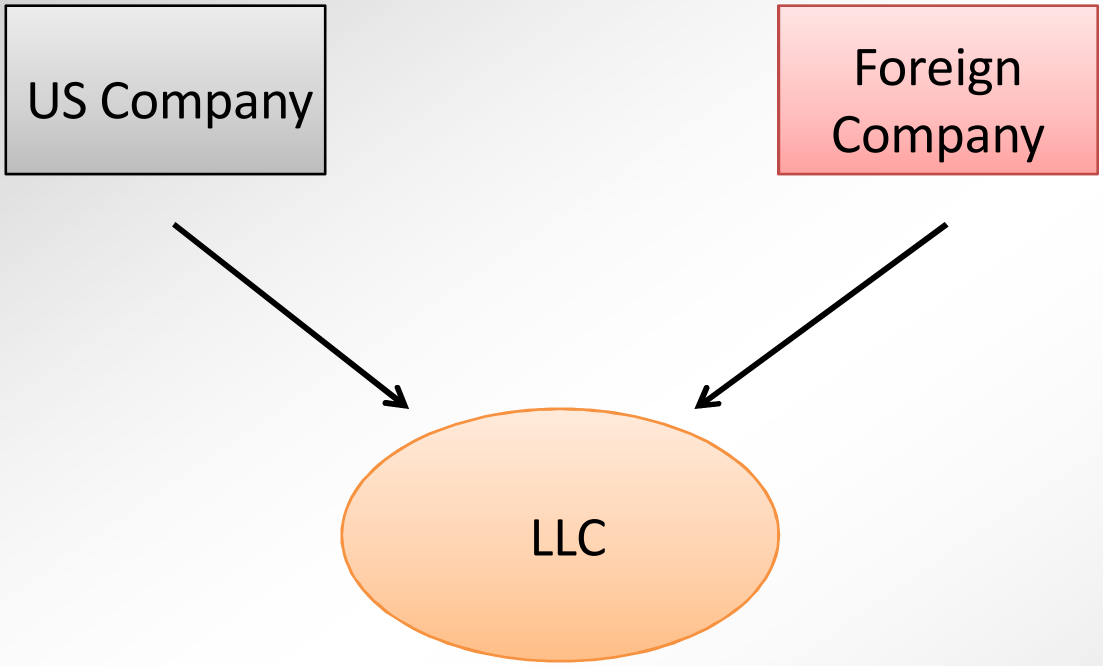
# 1248 AMOUNT ON SALE OF CONTROLLED FOREIGN CORPORATION

Section 1248

- Seller of Controlled Foreign Corporation (CFC) must treat as dividend gain to extent of E&P
- 1248 inclusion carries foreign tax credits
- 1248 amount determined at year end and pro rated based on day count, so post closing events can have an effect on the 1248 amount

# JOINT VENTURE STRUCTURES




- Section 367 Issues
- Disguised Sale